

STATE OF CALIFORNIA DEPARTMENT OF INSURANCE

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to the Workers' Compensation Insurance Claims Cost Benchmark and pure premium rates, California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **January 1, 2012.**

FILE NUMBER REG-2011-00022

DECISION AND ORDER

California's workers' compensation insurance system is unique when compared to other states. Insurance companies are largely free to set prices as they see fit and competition between those companies is intended to control pricing. Shortly after the repeal of the minimum rate laws and establishment of open competition in insurance rates in 1995, insurers under-priced premiums to increase market-share. At the same time significant cost increases developed, and a substantial number of insurance company insolvencies occurred. Following a period of market consolidation, system costs continued to be reflected in steep and unsustainable premium increases. Beginning in 2004, system reforms brought significant cost reductions and increased stability to the worker's compensation insurance market. Since the reforms, new cost drivers developed that are now exerting cost pressures on the worker's compensation system.

The purpose of the pure premium rate process is to review the costs in the workers' compensation insurance system and to determine a set of advisory pure premium rates that are reasonably predictive of those costs over the next year. The Department of Insurance does not set workers' compensation insurance rates, but this review is intended to confirm that rates filed by insurance companies are adequate to cover benefits for injured workers and to provide for reasonable claims adjustment expenses. The "pure premium rate" is the rate needed to cover the cost of benefits and adjustment expenses.

At my direction, the Workers' Compensation Insurance Rating Bureau ("WCIRB") submitted its pure premium rate filing and indexed it to current insurance company rate filings and pricing for workers' compensation insurance in its review. Without changing its process for analyzing workers' compensation costs, the WCIRB provided additional important information previously missing from its pure premium rate filings, including insurers' own cost estimates in their rate filings and the rate employers are ultimately being charged for their insurance premiums. As a result, we now have a better picture of the workers' compensation insurance market and are providing better information about cost trends to employers, workers compensation insurance companies, and the general public.

My staff reviewed the data supplied by the WCIRB as well as testimony and information submitted as a part of the extensive public hearing held on the WCIRB pure premium rate filing. The staff analyzed both current costs and trends in the workers' compensation insurance system. The staff's analysis is set forth in the Proposed Decision and Order attached hereto. After reviewing the Proposed Decision, I make the following determination:

The Approved Advisory Claims Cost Benchmark and Pure Premium Rates

The WCIRB is directed to adopt an Advisory Claims Cost Benchmark at \$2.30 per \$100 of employer payroll, and pure premium rates for individual classifications shall be adjusted based upon the classification relativities reflected in the WCIRB's filing in accordance with the adjustment of the Benchmark noted above. The WCIRB, the Department of Insurance and the public members of the WCIRB all presented pure premium rate proposals that fall within a narrow range and that are within a reasonable actuarial range.

The WCIRB recommended a pure premium rate of \$2.33 per \$100 of employer payroll. The Department of Insurance, after a full public hearing and review of the testimony and evidence submitted there, recommends adoption of a pure premium rate of \$2.30 per \$100 of employer payroll.

For the reasons set forth in the Proposed Decision, I agree with the Department of Insurance's proposed pure premium rate level recommendation, which differs slightly from the WCIRB's pure premium recommendation, because the WCIRB included in their analysis a portion of the State Compensation Insurance Fund's loss adjustment expense. I agree with the Department in excluding the loss adjustment expense of the State Compensation Insurance Fund.

Workers' Compensation Pricing and Transparency

The WCIRB filing demonstrates that insurers are currently charging premiums that are very close to the estimated cost of providing benefits and adjusting expenses. In spite of this fact, insurers filed substantially higher manual rates (rates that could be charged to employers). The fact that insurers are substantially discounting their manual rates has helped to keep workers' compensation insurance prices generally stable despite increasing costs.

The discounting of manual rates demonstrates that competition has been effective in holding down workers' compensation premiums, but this discounting must be carefully monitored in light of actual claims costs to ensure rate adequacy. For example, at present, for every \$1.00 of premium workers compensation insurers collect they incur \$1.26 for claims and expenses. The difference is made up through insurers' investment returns on reserves and surplus. This is welcome news for employers, since they are not experiencing dramatic increases in workers compensation premiums, yet this phenomenon may not be sustainable without addressing underlying cost pressure. The Department of Insurance will continue to closely monitor this trend to ensure that discounting is fair and financially responsible.

I also will require greater and more detailed information from the WCIRB and insurers related to costs and expenses. For example, the WCIRB is in the process of obtaining insurance company data on medical cost containment expenses, which previously was combined with

medical cost data. Medical cost containment expenses, including the cost of utilization review, have been increasing at a substantial rate and are now a larger relative cost to the system. The actual per unit cost of medical care has not been increasing at the same rate. The combination of medical cost containment data and actual per unit medical cost increase data masks the significant cost impact of medical cost containment efforts and can lead to erroneous conclusions about medical benefit cost drivers and erroneous policy responses. The WCIRB was not able to provide useful data for the Department to analyze this development, because it has not yet obtained sufficient separate data on medical cost containment expenses from its insurer members.

With this order I am directing The WCIRB to include disaggregated medical cost containment expenses of insurers and an analysis of that data in its next filing.

Improved Efficiency by Insurance Companies

Evaluating medical cost containment expenses is one part of looking at the efficiency of insurance companies delivering benefits to injured workers and keeping premiums to a reasonable level for employers. Despite some moderation in the severity of medical costs, the number of treatments per claim has increased significantly. Insurers must undertake efforts to evaluate their use of cost containment tools, such as utilization review, to determine if those tools improve the delivery of benefits, are effective, and actually reduce costs. At this point, the Department has little information with which to examine these important questions.

I will continue to work with employers, insurers, the WCIRB, other state agencies, interested members of the public, and researchers to evaluate and recommend options to improve efficiency and lower costs in the delivery of workers' compensation benefits.

Workers' Compensation Cost Drivers

Various cost drivers continue to impact the workers' compensation system despite the reforms enacted 7 years ago. These include increasing medical benefit costs, liens, and Medicare Set-Asides, as noted by my staff in their Proposed Decision. Policy makers, regulators, and the principal stakeholders of the workers' compensation system continue to grapple with these issues in search of equitable adjustments to the system that address cost drivers. Recently, the joint efforts of labor and employers resulted in changes to reign in the costs of prescription drugs and drug compounding through the enactment of Assemblymember Solorio's AB 378, which was signed by Governor Brown on October 7, 2011.

Further efforts are needed to reduce frictional costs in the workers' compensation system, including a reduction in the number liens filed over disputes on the cost of delivering benefits to injured workers. I support the current efforts of Senator Lieu to establish reasonable limitations on liens through the enactment of SB 863, which will revise the time period to file liens and how they will be handled. The Workers' Compensation Appeals Board should also complete their rule changes to allow for dismissal of liens that are not timely prosecuted.

I will work closely with the Governor and his Department of Industrial Relations to assist in evaluating and offering solutions to these issues.

ORDER

I hereby adopt the Proposed Decision and Order of Hearing Officer Christopher A. Citko dated November 4, 2011 in the above entitled matter and the directions to the WCIRB noted above as my Decision.

IT IS SO ORDERED THIS 4th DAY OF NOVEMBER, 2011.


DAVE JONES
Insurance Commissioner

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

PROPOSED DECISION AND ORDER

**JANUARY 1, 2012 WORKERS' COMPENSATION CLAIMS COST
BENCHMARK AND PURE PREMIUM RATES**

FILE NUMBER REG-2011-00022

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **January 1, 2012**.

SUMMARY OF PROCEEDINGS

A public hearing in the above captioned matter was held on September 27, 2011 at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2011-00022 dated August 23, 2011, which is included in the record. At the conclusion of that hearing, the WCIRB requested additional time to submit supplemental material. The hearing officer announced that the record would be kept open for additional written comment until 5:00 p.m. on Wednesday, October 5, 2011, and the record was closed at that date and time.

The record discloses the persons and entities to whom or which the Notices were disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted to the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated August 22, 2011 submitted by the Workers' Compensation Insurance Rating Bureau of California ("WCIRB") and related documents were available for inspection by the public at the Sacramento office of the California Department of Insurance ("Department") and were available online at the WCIRB website, www.wcirbonline.org.

The WCIRB's filings propose a change in the Workers' Compensation Claims Cost Benchmark and Pure Premium Rates ("Benchmark") that reflect insurer loss costs and loss adjustment expenses and adjustments to the California Workers' Compensation Experience Rating Plan—1995 to conform to the proposed Pure Premium Rates. In addition, the WCIRB has proposed amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and California Workers' Compensation Experience Rating Plan—1995.

The initial filing of the WCIRB requested that the Commissioner adopt a set of pure premium rates for each classification to be effective January 1, 2012, due to loss and Loss Adjustment Expense ("LAE") experience. On average, these pure premium rates would be at \$2.33 per \$100 of employer payroll, which is less than what California insurers have already filed with the department as the insurers' average pure premium rate of \$2.37 per \$100 of employer payroll. On August 23, 2011, the WCIRB submitted a letter amending its initial filing due to two typographical errors and provided amended rule changes as a result.

Testimony, both written and oral, was taken at a hearing in San Francisco on September 27, 2011, and exhibits were received into the record. Additional documentation requested by the hearing panel was submitted subsequent to the hearing but prior to the close of the time period to receive written comment along with correspondence and documents submitted by the public. The matter was submitted for decision at the conclusion of the period to receive written comment on October 5, 2011. The matter having been duly heard and considered, the following review, analysis, and Proposed Decision and Proposed Order are hereby made.

REVIEW OF WORKERS' COMPENSATION CLAIMS COST BENCHMARK AND PURE PREMIUM RATES FILING

Subdivision (b) of California Insurance Code Section 11750 states that the Insurance Commissioner shall hold a public hearing within 60 days of receiving an advisory pure premium rate filing made by a rating organization pursuant to subdivision (b) of Insurance Code Section 11750.3 and either approve, disapprove, or modify the proposed rate. Subdivision (b) of Section 11750.3 states that a licensed rating organization, such as the WCIRB, shall collect and tabulate information and statistics for the purpose of developing pure premium rates for its insurance company members to be submitted to the Commissioner. Pure premium rates are the cost of workers' compensation benefits and the expense to provide those benefits.

The pure premium rates approved by the Commissioner as a result of this process are only advisory. Insurers are free to accept or ignore the Commissioner's advice and make their own determination on the pure premium rates each insurer will use.

Chief Actuary Ron Dahlquist, with the assistance of Senior Casualty Actuary Giovanni Muzzarelli, provides below in the Actuarial Evaluation a review and analysis based upon the new filing information. This review is similar to previous reviews the Department conducted on pure premium rate filings, but the Department is now able to compare the proposed pure premium rates to insurers' actual rate filings. As was noted in last year's Proposed Decision, the pure premium rate process is important as a gauge or benchmark of the costs in the workers' compensation system but must reflect the reality of insurer rate filings and the premiums being charged to employers.

A number of comments were received into the record stating that the proposed pure premium rate filing from the WCIRB is a 40% increase in insurance rates, but no information or data has been provided to support these statements. The notion that there is such an increase in rates is incorrect for two reasons. First, the pure premium rate process does not address insurance rates and only estimates the costs of benefits and adjusting expenses for the upcoming policy period beginning January 1, 2012. The term "rate" can be confusing in the pure premium rate context since it is a measurement of cost per hundred dollars of employer payroll rather than the rates insurers may charge. Second, the data provided in the current filing shows that insurers have already increased, on average their own estimate of costs in their rate filings over the previous years. This becomes clear from the review below. The initial conclusions are the following:

- **Based upon a review of insurance company rate filings made with the Department, insurers already are using an average pure premium rate level that is \$2.37 per \$100 of employer payroll. This is very close to the pure premium rate level of \$2.33 recommended by the WCIRB. In other words, insurers have already increased their pure premium rates in line with past recommendations of the WCIRB. As a result, it is not expected that changes in the level of the approved advisory pure premium rates will result in similar changes in insurance companies' filed pure premium rates or actual premiums charged to employers; in fact, we expect changes in filed pure premium rates to be relatively minor.**
- **Insurers are discounting their filed manual rates, the rates that insurers would normally use to price employer premiums before any discounts or surcharges. This has resulted in premiums being charged to employers that are on average close to the cost of claim benefits and adjusting expense. Insurers' filed manual rates are at \$3.27 per \$100 of employer payroll on average, while the rates charged to employers are averaging \$2.38 per \$100 of payroll. Insurers are generally discounting their filed rates substantially and are thus reducing the premiums charged to employers for workers' compensation insurance.**

- **These figures are not predictive of an individual employer's insurance premium. That premium may fluctuate greatly from these figures based upon an employer's business, the mix of employees and operations, and the employer's actual claims experience. To determine an individual employer's premium from these figures or the Commissioner's determination on pure premium rates is not possible since the Department is only reviewing pure premium rates as one component of insurance pricing.**

Actuarial Recommendation

The WCIRB has proposed an average pure premium rate level of \$2.33 per \$100 of payroll in its January 1, 2012 rate filing. CDI staff actuaries' analysis results in an average pure premium rate level of \$2.30 per \$100 of payroll for reasons set forth in the "Actuarial Evaluation" section that follows. The current industry average level of pure premium rates filed by insurers with the Department is currently \$2.37 per \$100 of payroll, while the WCIRB's January 1, 2011 pure premium rate filing of one year prior recommended an average level of \$2.12 per \$100 of payroll. While the indicated pure premium rate level represents our central estimate, and thus our recommendation, we note that both the WCIRB pure premium rate proposal and the proposal from the Public Actuary are within a reasonable actuarial range, as is the industry average filed pure premium rate level of \$2.37 per \$100 of payroll.

This WCIRB filing compares its proposed average pure premium rate level to the average industry filed pure premium level. We believe this comparison is useful. It provides an appropriate basis for assessing both the industry's ability to adapt to the proposed pure premium rate level and the size of the potential market impact of such an adjustment. Given that the proposed pure premium rate level is very consistent with the industry's current average filed pure premium rate level, there should be very little difficulty for the market to adapt to the proposed pure premium rates if individual insurers so desire. It is also likely that little market impact would result from their adoption. We note that the WCIRB proposed pure premium rates are advisory, and insurers are free to make their own decisions as to what pure premium rates they will use in their rate filings. Insurers have proven their willingness over time to exercise their own independent judgment, and we cannot predict the decisions insurers will make with respect to their rate and price levels.

We note that the market currently utilizes a substantial level of schedule credits, averaging something on the order of 20% of manual premium. Collected premiums at actual charged rates in 2011 were on average approximately 15% greater than the WCIRB's January 1, 2011 recommended advisory pure premium rates, suggesting a high level of competition in the market. Our review of the California workers' compensation insurance industry's profitability indicates that the pricing environment is benefiting from substantial investment income relating to substantially higher premiums in prior years and associated reserves, resulting in an average market price level that is below what would be sustainable without this underlying level of support.

Actuarial Evaluation

The actuarial evaluation will focus on three main components of the analysis: 1) Loss Development, 2) Loss trends, and 3) LAE (Loss Adjustment Expense) provision.

1. Loss Development

The WCIRB utilizes a range of actuarial methods to develop estimates of the medical and indemnity components of ultimate loss. For the January 1, 2012 filing, these various methodologies produced a range from \$2.02 per \$100 payroll to \$2.73 per \$100 payroll, relative to the WCIRB's proposal of \$2.33.

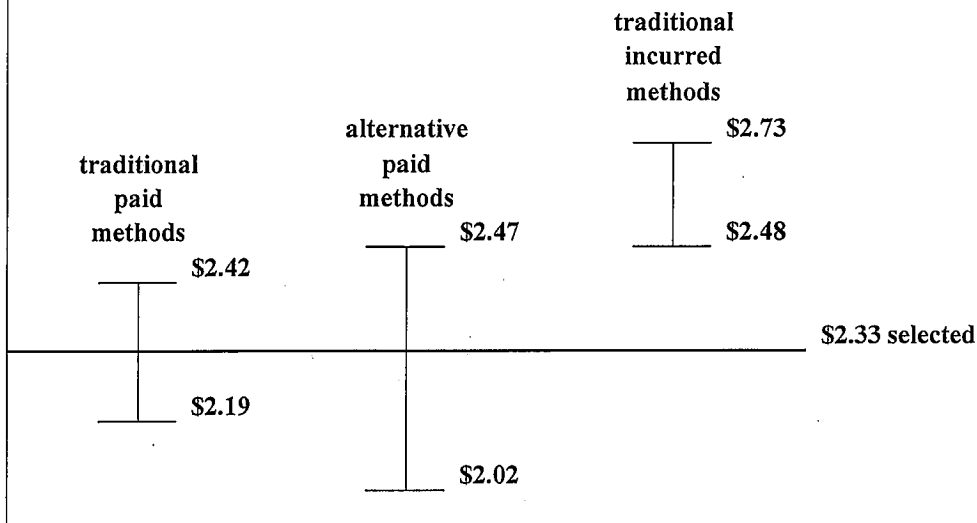
As shown in Table 1, these methods can be categorized into three main types: traditional paid methods, alternative paid methods, and incurred methods. The traditional paid methods reflect historical payments by accident year, with the various alternative indications reflecting the latest year paid development versus the most recent 3-year average, with and without adjustments for changes in insurer mix, and with and without adjustments for reform and for changes in claim settlement rate. Generally the traditional paid methods have performed the best in terms of stability and accuracy.

The alternative paid methods also reflect historical payments, but do so as a function of underlying exposure and assume that payments across time are not connected. These methods generally produce a somewhat wider range of results than the traditional paid methods but centered on approximately the same level as the traditional methods, and include review of the latest year versus the most recent 3-year averages.

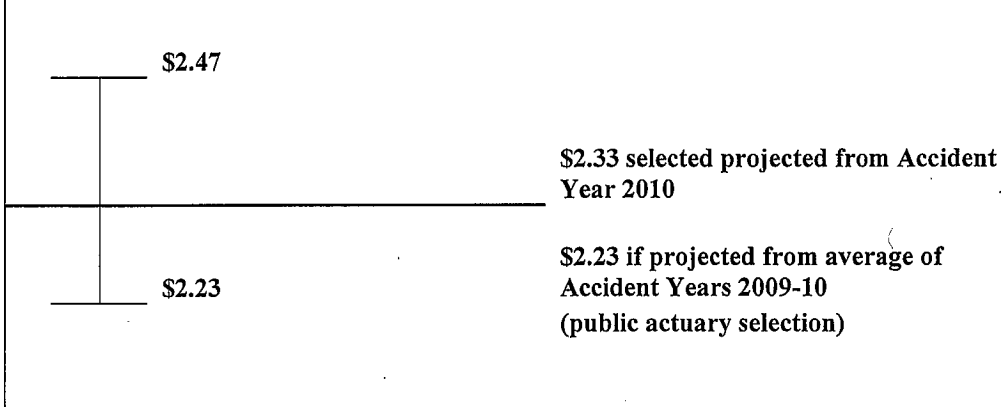
Incurred methods reflect historical loss payments plus associated case reserves. Due to changes in case reserving practices over time within a given insurer and changes in insurer mix, the incurred methods generally do not produce results that are as stable or accurate as those produced by the paid methods, and thus are not given any weight in the selection process. These methods include a review of latest year versus the most recent 3-year average, and with and without adjustments for changes in insurer mix and changes in case reserve adequacy.

The WCIRB selected as its loss development assumption the "latest year paid, adjusted for reform" method. The CDI and the Public Members' actuaries agree with the range of methods reviewed by the WCIRB and with the WCIRB's selection.

Further, both the CDI and Public Members' actuaries support the WCIRB's change in opinion on the usefulness of one particular traditional paid method, the paid Berquist-Sherman method. While this method attempts to make adjustments for changes in claims settlement rates over time, the results of the method currently appear to be less accurate and stable than other traditional paid methods. As a result, it was not used as a basis for the final selected rate level. While the paid Berquist-Sherman method is an appropriate method under certain circumstances, in this particular application the results do not appear to support the use of a model with additional complicating assumptions.

Table 1**Range of Various Loss Development Methods on 1/1/2012 Pure Premium****2. Loss Trends**

The WCIRB utilizes a range of trending assumptions to roll-forward the estimates of ultimate loss developed above to the time period reflected in the filing. As shown in table 2 for the January 1, 2012 filing, these various trend assumptions produce a range from \$2.23 per \$100 payroll to \$2.47 per \$100 payroll, relative to the WCIRB's proposal of \$2.33.

Table 2**Range of Different Trend Assumptions on 1/1/2012 Pure Premium**

The various trend assumptions vary in terms of 1) the particular historical time period used to determine severity and frequency trends, and 2) also the point in time at which these trends are applied to roll forward to the future time period of the filing. As shown in tables 3 and 4, medical and indemnity severity trends over the more recent time frame (2005-2010) have decreased relative to longer-term historical averages(1991-2003), with the resulting selected trends by the WCIRB coming in several points lower than last year's filing and more consistent with the CDI's and Public Members' Actuaries' recommendations from last year. CDI believes that the higher 1991-2003 trends may not be appropriate since that time period is heavily impacted by the run-away inflation in medical costs of the pre-reform years.

CDI actuarial staff and the Public Members' actuary agree with the WCIRB selected trends.

Table 3

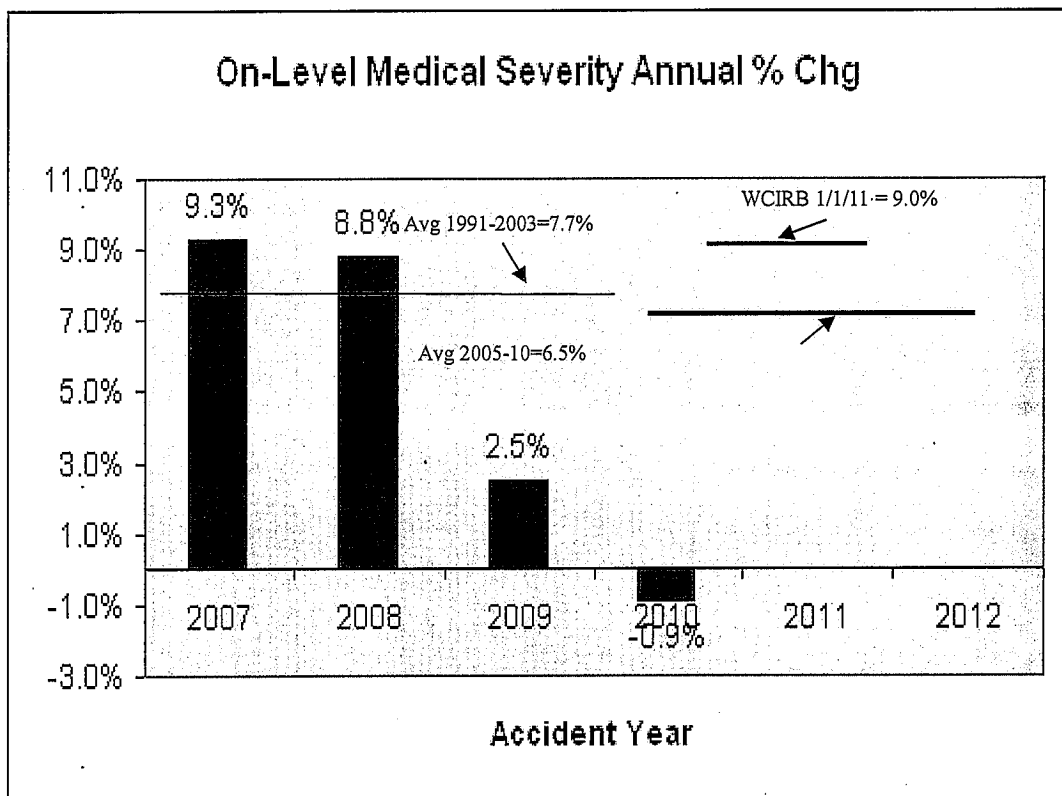


Table 4

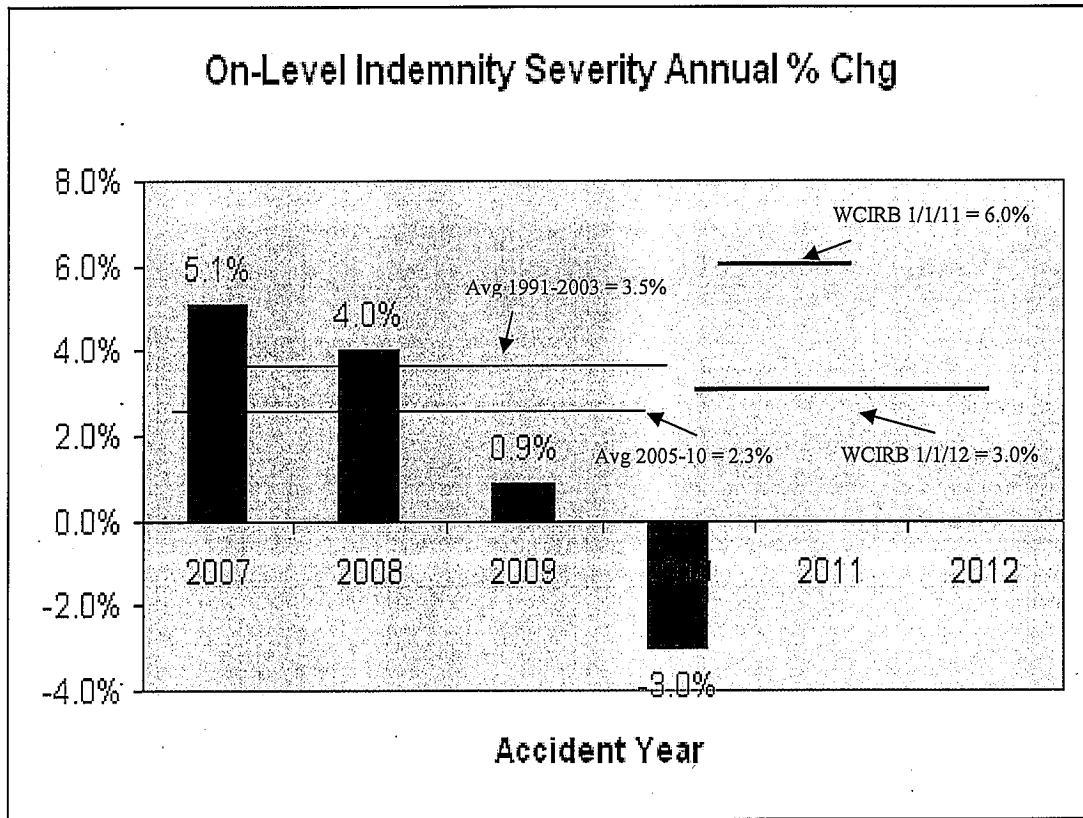
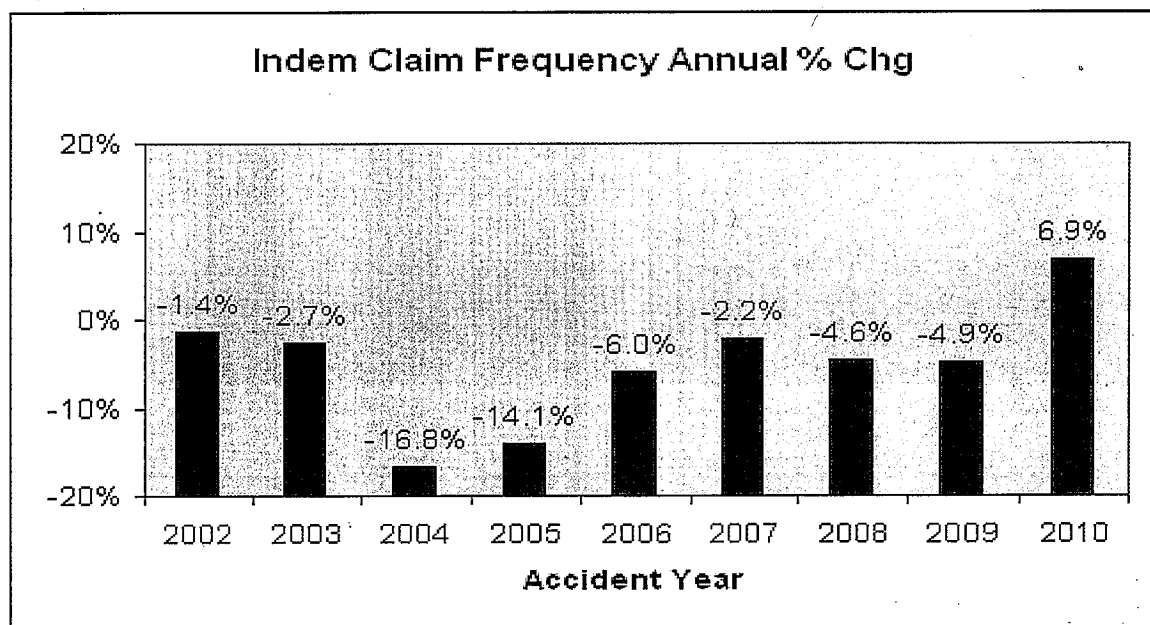


Table 5



We note that the negative severity changes indicated for accident year 2010 are driven by the unusual 7% increase in frequency shown in Table 5 above. The WCIRB is performing ongoing analysis to help determine the driver(s) of this frequency increase, with one possible explanation that this is a result of an increase in small claims that previously were medical-only claims, possibly connected to the state of the economy. The National Council on Compensation Insurance (NCCI), which provides data collection and rate development for approximately 35 states and performs a role similar to the WCIRB in California, has noted this increase in frequency nationwide.

The main difference of opinion on the trend issue between the Public Members' actuary and the WCIRB is the point in time at which these trends should be applied. The WCIRB selects accident year 2010 as the starting point, whereas the Public Members' actuary selects the average of accident years 2009 and 2010. The use of the average of the most recent two accident years had been the standard approach by the WCIRB, but in their verbal testimony at the Rate Hearing the WCIRB indicated that the use of the single accident year 2010 was preferable due to the impact of an increase in frequency noted in 2010, which result in severities for accident year 2010 appearing low relative to prior years. CDI staff actuaries believe that the higher incidence of small claims observed in accident year 2010 is likely to continue in the future, and we concur with the WCIRB's use of accident year 2010 as the baseline for trending purposes. In addition, review of an additional quarter of data indicated a slight increase in loss estimates versus that reflected in the filing. We believe this adds further support to the conclusion that reliance on accident year 2010 alone as the basis for trending is appropriate.

A key issue is the need to maintain diligence around potential increases in medical cost inflation. As seen in tables 6 and 7, over the last several years medical cost inflation has remained high in spite of the medical cost controls put in place by the recent reforms in 2004 and 2005. We note that the detailed data underlying this analysis comes from the California Workers Compensation Institute (CWCI), which is a different data source than the aggregated data used by the WCIRB in its rate filing.

Table 6

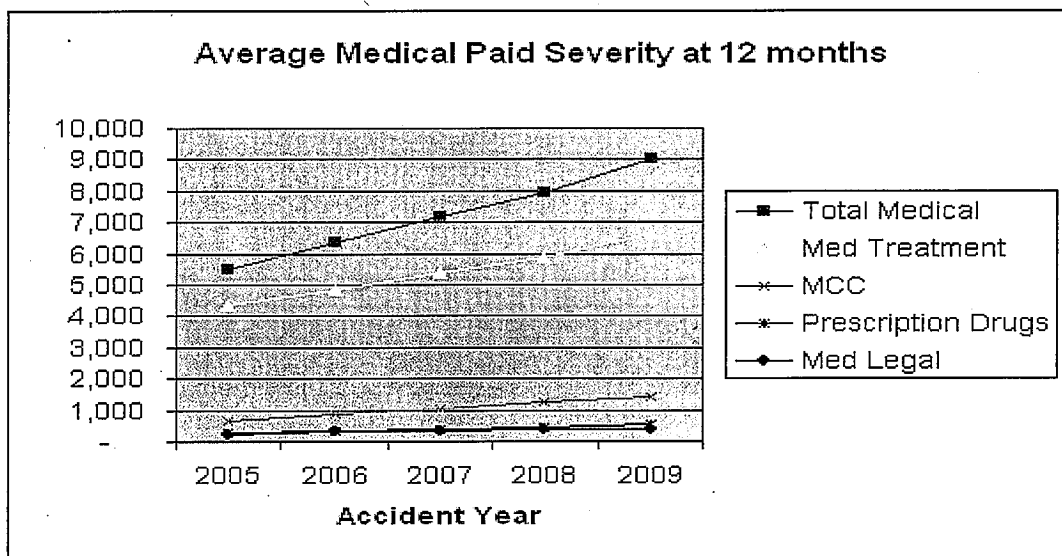


Table 7

Change in Medical Severity by Cost Component % change at 12 months versus year prior at 12 months					
Accident Year	Total Medical	Medical Treatment	MCC	Prescription Drugs	Medical Legal
2006	16%	11%	38%	24%	46%
2007	13%	12%	20%	16%	14%
2008	10%	9%	19%	7%	8%
2009	14%	13%	16%	26%	6%

It appears that unit cost inflation has remained largely in check, but the level of utilization (number of doctor visits and number of procedures per doctor visit) has increased by 50% - see table 8. Furthermore, the costs associated with medical cost containment efforts enacted by the recent reforms have also continued to increase, even as the aforementioned medical treatment costs continue to increase, raising the question of their effectiveness. One concern is that medical inflation by component appears to be settling into a high single-digit or low double-digit range, with implications of future rate increases of similar magnitude if costs are not effectively controlled going forward.

Table 8

Change in Workers Compensation Utilization % change 2010 vs 2005				
	Average Paid \$ per procedure	Average Procedures per visit	Average Visits per claim	Avg \$ per claim
All Services	-2%	27%	22%	53%
Evaluation & Mgmt	17%	27%	17%	74%
Surgery	2%	12%	14%	31%
Radiology	-3%	12%	11%	20%
Physical Medicine	-4%	32%	13%	43%

3. Loss and Loss Adjustment Expenses

In its determination of the provision for loss adjustment expenses (LAE) in the proposed rates, the WCIRB developed separate indications for the allocated loss adjustment expense (ALAE) and unallocated loss adjustment expense (ULAE). In doing so, the WCIRB considered the historical ALAE and ULAE experience of all companies in the market, including the State Compensation Insurance Fund (SCIF).

CDI staff actuaries believe that the WCIRB's methods for determining ALAE and ULAE are generally reasonable, and we accept them with the exceptions noted in the following discussion. There are two main issues to be discussed for LAE: 1) the appropriateness of using SCIF experience for the development of the LAE provision in the rates, and 2) the appropriateness of the trend assumptions underlying the ALAE provision.

While ALAE ratios to loss are reasonably consistent between private carriers and SCIF, the ULAE indication for SCIF is much higher than for private carriers. The WCIRB addresses this issue by tempering the weight applied to SCIF (its market share) by 50%. The result of the tempering is a ULAE ratio to loss of 9.5%, versus 7.7% for private carriers (see table 9). SCIF's LAE ratios include a significant component of excess expense, and CDI staff actuaries believe this excess expense should not be included in a prospective estimate of industry average costs required to settle claims in the future. The Public Members' actuary concurs with CDI on this issue. The impact of excluding SCIF experience from both the ALAE and ULAE is a reduction in the indicated average pure premium rate from \$2.33 to \$2.30.

Table 9

LAE Provision Underlying 1/1/2012 Rate Filing			
	All Carriers	Private Carriers	WCIRB Selected
ALAE/Loss	15.2%	16.3%	15.9%
ULAE/Loss	12.1%	7.7%	9.5%
Total LAE/Loss	27.3%	24.0%	25.4%
Indicated Rate		CDI* \$2.30	WCIRB \$2.33
* CDI indicated rate is based on private carrier LAE/loss %.			

With regard to the trend assumption underlying the ALAE provision, the WCIRB reviews a number of different methods and considers various trend periods as well as trend bases. The range of these various methods for the private carriers is 13.1% to 18.0% of loss, versus the WCIRB's selected method indication of 16.3% (for private carriers). The trend underlying the selected method is a 6% change in ALAE dollars per indemnity claim per year. The Public Members' actuary notes an indicated trend for ALAE over the last several years of approximately 10%, which is reflected in the high method estimate of 18.0%. CDI staff actuaries believe that the higher trend observed in the post-reform period 2005-2010 reflects a ramping up of ALAE as a side effect of the reforms and that the going-forward trend for ALAE will moderate and be more consistent with the average loss trend. Since this is composed of medical severity trend of 7% and indemnity severity trend of 3%, we accept the WCIRB ALAE trend of 6%.

A comment regarding medical cost containment expenses is also appropriate here. At the September 27 public hearing, the Commissioner asked the WCIRB to explain how it had treated medical cost containment expenses in the filing. The prior Commissioner's Decision on the January 1, 2010 pure premium rate filing required the WCIRB to change the basis of reporting of medical cost containment expenses. Prior to that Decision, these expenses were reported as part of losses; that Decision requires them to now be reported as loss adjustment expenses in order to conform to statutory accounting requirements promulgated by the National Association of Insurance Commissioners.

Because this change in reporting requirements is relatively new, the WCIRB only has separate medical cost containment expense data on an accident year basis for policies incepting on or after July 1, 2010. This means that it has essentially no separate accident year history of these expenses. The WCIRB attempted to determine the impact on accident year trends that would result from removing available calendar year medical cost containment data from its accident year loss data. It also attempted to remove accident year medical cost containment data provided by CWCI in a similar calculation. These calculations yielded indications of modest reductions in medical severity trends; however, CDI staff actuaries cannot place any confidence that these indications are reliable, given the gross imprecision of the approach. In our opinion, it is simply not possible to perform a credible analysis given the extreme data limitations.

4. Studies Related to Issues of Increasing Medical Costs and Effectiveness of Reforms

For several years, and as noted above in the Actuarial Evaluation section, CDI staff and other observers have commented on increasing medical costs post-reform and the fact that this increase is occurring despite the controls put in place by the reforms to manage medical costs. The prior Insurance Commissioner held a separate hearing in conjunction with the July 1, 2009 WCIRB rate filing to investigate ongoing medical cost increases, and CDI staff have recommended in prior rate decisions that the effectiveness of the reforms should be studied. Given that these high medical loss trends have persisted beyond the point of merely adjusting to a new post-reform environment, we feel that it is

important to evaluate the effectiveness of the reform provisions and to assess what can be done to improve system efficiency and effectiveness.

Several relevant studies have recently been completed, which provide useful insight into the concerns noted above. The first is a broad study on the overall impact of the 2004 reforms by the RAND Institute, which was commissioned by the Commission on Health and Safety and Workers Compensation (CHSWC) and published in August 2011. The second study is a more specific review by CHSWC on the impact of liens on the workers' compensation system. A third study performed by Mr. Neuhauser of the Center for the Study of Social Insurance at UC Berkeley addresses the increasing impact of Medicare set-asides on the California workers' compensation system.

RAND Study

The RAND study released in August 2011 provides a broad overview of the various reforms and the financial impacts of substantial reductions in loss severities and overall losses within the system immediately after implementation of the reforms starting in 2005 and notes the return of high loss and expense trends over the last several years, consistent with observations in the Actuarial Evaluation section above. The study evaluates service utilization intensity, addressing costs per service and number of services per workers compensation claim.

The RAND analysis, which includes a comparison to the utilization levels of 15 states by medical service, suggests a relatively high level of medical evaluation and management in California when compared to other states. In addition, post-reform utilization levels within California across most services remain relatively unchanged from pre-reform levels, with the primary exceptions being chiropractic care with a reduction in utilization of 70% and physical medicine with a reduction of 60%.

As noted in the Actuarial Evaluation section above, costs per service have remained relatively flat since the reforms, due to the fee schedule imposing tight cost limitations on a per-service basis. However, the number of procedures and number of visits per claim have increased by a combined 50%, driving the observed high loss trends and indicating that care providers are maintaining high revenue where the reforms have not instituted tight controls. This is in marked contrast to the substantial decrease in chiropractic care costs, one area where the 2004 reform introduced an explicit limitation on number of office visits.

The RAND study includes a set of recommendations for improving the efficiency, accountability, and monitoring of medical care within the workers compensation system and highlights the need for further study addressing cost drivers and quality of care. We recommend that policy-makers consider RAND's specific recommendations and pursue further study of those areas identified by RAND as needing additional study. We further believe that particular attention should be paid to ensuring that effective controls are put in place across the board and that serious consideration should be given to additional explicit utilization limits, such as those that have proven effective for chiropractic care.

CHSWC – Liens

This CHSWC study published in early 2011 provides an instructive look at the negative impact liens have on the California workers' compensation system. The study documents the severe and growing backlog of workers compensation liens, driven by a lack of disincentives to file liens and inadequate regulatory controls that allow the filing of liens with little merit.

Liens result in a significant amount of administrative cost to insurers as well as the workers' compensation court system. Since it can cost \$1,000 to handle and defend against a lien, it is often in the insurers' economic interest to settle lien claims regardless of merit. This has resulted in "good" liens settled for less than they should and "bad" liens settled for more than they should.

Liens can be grouped into several categories: i) medical treatment where there is a dispute over reimbursement to a medical provider, ii) interpreter (reimbursement for such services since interpreter services are required for workers compensation), iii) copy services, and iv) other. The interpreter and copy liens are problematic because of their volume in spite of their low cost. Most of the interpreter and copy claims could be eliminated with a more complete fee schedule addressing these services. Many of the medical treatment claims could also be eliminated with a further clarified fee schedule, but the key issue for medical claims is that inadequate regulatory language allows liens to be brought with no effective statute of limitation and even after the medical provider originally accepted payment in full.

Substantial improvements to the workers compensation system could be achieved with fee schedule refinements addressing interpreter and copy services, as well as certain medical services, and with a focus on regulatory language that provides an effective and appropriate statute of limitations and controls on all liens.

Neuhauser - Medicare Set-asides

Medicare set-asides are having an increasing impact on the California workers' compensation system since Medicare is requiring that extra monies be set aside to pay for work-injury medical care so it will not be paid by Medicare. Medicare appropriately wants to ensure that work-related injuries covered by the workers' compensation system are not in part paid by the Medicare program, especially when such claims are settled by a lump-sum payment. In addition, Medicare set-asides include a heavy administrative cost to tracking how much insurers need to reserve or "set-aside" on an individual claim basis. The additional loss dollars currently attributed to Medicare set-asides are estimated at 4% of current medical payments and are projected to rise to 15% of medical payments by 2025 as the population of older workers increases.

In his written submission, Mr. Neuhauser describes a proposal to significantly lessen the administrative burden by building into the workers compensation rate a provision for the Medicare set-aside and settling with the government on an aggregate state basis. While it

is unclear how likely such a proposal is to be adopted, such a proposal may have the beneficial effects of lowering costs, due to the substantial reduction in the administrative burden, and improving Medicare funding levels by eliminating current unavoidable deficits due to settling claims on an individual claim basis.

While not actively involved in legislative discussions regarding Medicare set-asides, the WCIRB is fully aware of ongoing activity and is currently evaluating the general subject. Since there likely will be rate-making implications as this issue becomes more important, CDI staff actuaries recommend that the WCIRB continue its efforts to remain current with this issue.

5. The Relationship of the Proposed Pure Premium Rates to Current Industry Filed Pure Premium Rates, Manual Rates, Final Charged Rates, and Insurer Profitability

Based on data developed by the WCIRB, it appears that the industry average filed pure premium rate level of \$2.37 is 1.8% higher than the WCIRB proposed pure premium rate of \$2.33. Further, the average filed manual rate of \$3.27 indicates an average loading for expenses and underwriting profit (less investment income offset) of 38.0% of pure premiums or 27.5% of manual premium. Comparing it to final charged rate levels of \$2.38 indicates a substantial use of schedule credits by the industry.

The average combined effect of all rating plan discounts is an average discount of about 27.5%. This appears to be a high level of discounting of insurers' manual rates; however, it should be noted that this average credit includes premium discount for at least one major insurer, and that insurer's average premium discount is about 10% of manual premium. It is reasonable to conclude that the industry wide average rating plan discount excluding premium discount is probably closer to 20%, although this must be considered approximate without detailed further analysis which is not practical for our current purposes.

We believe that the primary reason why insurers are willing and able to offer such discounts is due to the unusually high level of investment income arising from premiums and reserves associated with policies written in prior years at higher rate and loss levels during the pre-reform era. As indicated in WCIRB's Summary of December 31, 2010 Insurer Experience published April 20, 2011, the industry calendar year combined ratio, which reflects losses and expenses as booked by the industry in aggregate and excludes investment income, was 116% for 2010. This generated a return on net worth of approximately 4 to 5%. The industry reported investment income of approximately 25% of premium (pre-tax) in 2010 is 8 to 10 points higher than would be the case if reserves and associated assets were more in line with current premium volumes. Further, the WCIRB projects Loss and LAE ratios for Accident Year 2010 to be 8 to 10 points higher than what the industry has booked. As the industry continues to hold reserves in excess of WCIRB indications across all Accident Years in aggregate, current market pricing appears sustainable in the near- to mid-term, However, current price levels are clearly not sustainable in the long-term.

**DETERMINATION OF WORKERS' COMPENSATION CLAIMS COST
BENCHMARK BASED UPON CURRENT FILING**

It is the determination of this Hearing Officer that the Insurance Commissioner adopt the Benchmark at an average pure premium rate level of \$2.30 per \$100 of payroll to be effective with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Pure premium rates for individual classifications shall be adjusted based upon the classification relativities reflected in the WCIRB's filing in accordance with the adjustment of the Benchmark noted above. The change in the Benchmark determined herein is based upon the hearing testimony and an examination of all materials submitted in the record as well as the Actuarial Recommendation and Evaluation set forth above by Department of Insurance Chief Actuary Ron Dahlquist.

OTHER MATTERS

Amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995 ("USRP")

The WCIRB has proposed amendments to the USRP to be effective on January 1, 2012 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Those amendments are contained in the WCIRB's filing and summarized in the Notice of Proposed Action and the Initial Statement of Reasons.

Amendments to the USRP contained in the filing have been reviewed, along with the trade group notices and other materials provided by the WCIRB. Comments were received concerning only one of the USRP changes:

- Amend Classification 3620(1), Boilermaking — plate steel — N.O.C., to provide that this classification includes the manufacture of boilers, water heaters and autoclaves.

Specifically, a letter was timely received from California Senator Alan Lowenthal concerning the proposed rule change and its affect upon an autoclave manufacturer, Taricco Corporation. Included with the letter was correspondence from Taricco Corporation to the WCIRB dated July 22, 2011 and a copy of a decision issued by the Insurance Commissioner involving the classification of autoclave manufacturers and how it is to be applied to Taricco Corporation. See *In the Matter of the Appeal of Taricco Coporation*, Case No. AHB-WC-10-8 (January 21, 2011) ("*Taricco*"). Senator Lowenthal requested that the rule change proposed by WCIRB be reviewed in light of the Commissioner's decision in the *Taricco* matter and the possible impact the rule change would have on Taricco's workers' compensation rate. It should be noted that the materials from Senator Lowenthal were provided after Senator Lowenthal's staff contacted this hearing officer, asked about the rule change, and were asked to provide comments to be reviewed as part of this rule-making process before the record in this matter closed.

The materials from Senator Lowenthal, as noted above, were reviewed along with the information provided by the WCIRB. The materials from the WCIRB concerning this rule change consisted of trade group notices to three entities including, Taricco Corporation, informing these entities that a rule change may occur; a second notice that the rule change was approved by the WCIRB's Classification and Rating (C&R) Committee and would be filed with and heard by the Commissioner at these proceedings; emails from WCIRB to Taricco Corporation providing notice of the C&R Committee meeting and the result from that meeting; and the minutes from the C&R Committee meeting concerning the proposed rule change.

It is surprising that the WCIRB did not provide any of the information provided by Senator Lowenthal, which has direct importance on the requested change. For example, the letter of Taricco sent to the WCIRB's C&R Committee in response to its proposed rule change sets forth a number of reasons why the change should be not made and the lack of sufficient information for the change. Despite the C&R Committee's decision, this information is not noted in the minutes nor disclosed to the Commissioner with the WCIRB's filing. It is imperative that the WCIRB disclose facts that are both favorable and unfavorable to the promulgation of rules that affect it and its members.

There continues to be insufficient information or analysis for this rule change. In fact, the Administrative Law Judge's analysis in the Taricco matter continues to provide the strongest support to deny this rule change at this time. Judge David R. Harrison pointed out that the WCIRB's staff, despite assigning autoclave manufacturers by analogy to the boilermaking classification for many years, had insufficient information or evidence to support such assignment by analogy when there was a more general classification that could be assigned. The directions given by Judge Harrison to the WCIRB to seek a rule change do not appear to be directions to just amend the classification. Rather, there is need for proper evaluation and support for analogizing autoclave manufacture with boilermaking or making the rule change. However, the WCIRB appears merely to have decided to change the rule with very little additional information.

Additionally, there is no discussion in either the ruling of Judge Harrison or in the WCIRB's filing as to why Taricco's plate steel operations were not classified in Classification 3620(2)—Plate Steel Products Fabrication. Obviously, autoclaves are not boilers, but autoclaves may be a plate steel fabricated product that fits within Classification 3620(2). Rather than speculate concerning this, the WCIRB is directed to review this matter further and provide additional information regarding classification of autoclave manufacture to support any further amendment regarding those operations. Therefore, the amendment to Classification 3620(1), Boilermaking — plate steel — N.O.C is denied. The WCIRB is further directed to assign all autoclave manufacture to the general classification of 3560(2), Machinery Mfg.—Industrial—N.O.C in the meantime as determined by Judge Harrison.

The remaining amendments to the USRP have been reviewed and, having received no objections to them, are approved as being reasonable and consistent with the purpose of the USRP.

Amendments to the Miscellaneous Regulations for the Recording and Reporting of Data

The WCIRB has proposed amendments to the Miscellaneous Regulations for the Recording and Reporting of Data to be effective on January 1, 2012 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Those amendments are contained in the WCIRB's filing and summarized in the Notice of Proposed Action and the Initial Statement of Reasons. The amendments, having been reviewed and having received no objections, are approved as being reasonable and consistent with the purpose of these Miscellaneous Regulations for the Recording and Reporting of Data.

Amendments to the California Workers' Compensation Experience Rating Plan—1995 (ERP)

The WCIRB has proposed amendments to the ERP to be effective on January 1, 2012 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Those amendments are contained in the WCIRB's filing and summarized in the Notice of Proposed Action and the Initial Statement of Reasons. The amendments to the ERP, having been reviewed and having received no objections, are approved as being reasonable and consistent with the purpose of the ERP. However, the WCIRB is directed to adjust the eligibility threshold in the ERP to reflect the Insurance Commissioner's adopted Claims Cost Benchmark in order to maintain approximately the same volume of experience rated employers.

Use of Self-Insurance Data

A letter was received from Finish Line Self-Insurance Group, Inc. ("Finish Line"), over concerns that the pure premium rates for classifications 8278 (Racing Stables—Jockeys) and 8631 (Horse Trainers) were not properly reported since they did not include loss data for employers in a captive insurance program and a self-insurance group. Finish Line offered additional data combining both the captive program and self-insurance group to reduce the pure premium rate increase proposed by the WCIRB in these classifications.

This information is informative and not unexpected. However, the data from non-insurance sources cannot be used. The WCIRB may only rely upon data provided by insurance companies and may not include data of self-insured employers. It should also be pointed out that pure premium rates are only advisory and the changes requested by the WCIRB are to bring the loss data current for insurance companies.

PROPOSED ORDER

WHEREFORE, IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8 that the advisory workers' compensation pure premium rates filed by the WCIRB and Sections 2318.6, 2353.1 and 2354 of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein;

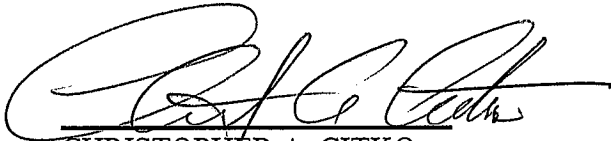
IT IS FURTHER ORDERED that pure premium rates for individual classifications shall change based upon the classification relativities reflected in the WCIRB's filing to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark and advisory pure premium rates as specified herein;

IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark and advisory pure premium rates; and

IT IS FURTHER ORDERED that these regulations shall be effective January 1, 2012 for all new and renewal policies with anniversary rating dates on or after that date.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on September 27, 2011, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

NOVEMBER 4, 2011

A handwritten signature in black ink, appearing to read 'C. Citko', written over a horizontal line.

CHRISTOPHER A. CITKO
Senior Staff Counsel